SECTION III:

OVERVIEW OF FINANCIAL PERFORMANCE: ANALYSIS AND INTERPRETATION

Overview of Financial Performance: Analysis and Interpretation

FINANCIAL STATEMENT REPORTING

HHS has prepared Departmentwide audited financial statements since FY 1996. Financial statements are also prepared for all OPDIVs (CDC's include ATSDR); the nine largest are audited. The audited OPDIVs account for virtually all HHS assets and expenditures. HCFA, FDA, CDC, and NIH prepare their own financial statements and the remainder are prepared by the PSC. In addition to the Departmentwide audited statements, OMB only requires "stand-alone" audited financial statements for HCFA. However, HHS management believes that each OPDIV should take responsibility for its own financial management, and there is no better measure for financial accountability than a financial audit opinion from a professional independent third party. Therefore, we submit the financial statements of our other OPDIVs for voluntary audits. In order to complete our Departmentwide FY 1998 audit in a timely manner, audit resources were shifted. The result was that some OPDIV audits will not be completed until after the completion of the Departmentwide audit.

This year's accountability report reflects a change from previous reporting formats, so statements showing prior year comparisons are not presented. While the balance sheet remains basically the same, there are other new financial statements required under new accounting standards.

In this Accountability Report, HHS is presenting its Departmentwide FY 1998 audited financial statements. Readers are encouraged to refer to Section IV of this report for the actual financial statements, notes and supplemental schedules, and to the HHS FY 1997 Accountability Report for FY 1997 audited financial statements.

Definitions of Financial Statement Asset Categories

Entity Assets are those assets which the reporting entity holds and has the authority to use in its operations.

Non-entity assets are those assets which the reporting entity holds but does not have the authority to use in its operations.

Intragovernmental assets are those assets that arise from transactions among Federal agencies.

FINANCIAL STATEMENT AUDIT FINDINGS AND MANAGEMENT COMMENTS

HHS received a qualified opinion on the Departmentwide FY 1998 financial statements. For details, please see the auditor's opinion in Section V. The following qualifications (scope limitations) were cited:

- Medicare Contractor Accounts Receivable, and
- New Financial Statements.

We are pleased that several FY 1997 audit qualifications have not been identified as qualifications for FY 1998 including:

- Cost Reports,
- Intra-Entity Departmentwide Transactions,
- Net Position, and
- Grant Accounting.

Corrective Action Plans to resolve audit findings are prepared quarterly at the Departmentwide and OPDIV levels. These plans will guide our efforts as we strive for a "clean" Department opinion for FY 1999 and as we work to resolve our internal control material weaknesses and reportable conditions.

Individual OPDIV audit findings were not all finalized as this report went to print. When available, those reports will be posted to the respective OPDIV home pages. Those addresses are found on the inside front cover of this report.

Comparision of Departmentwide Audit Findings: FYs 1996 - 1998

Issue Category	FY 1996		FY 1997		FY 1998	
	Qualification Causing Disclaimer of Opinion	Material Weakness	Qualification Causing Qualified Opinion	Material Weakness	Qualification Causing Qualified Opinion	Material Weakness
Medicare Accounts Payable	X	X*		X		
SMI Revenue	X					
Medicare/ Medicaid Accounts Receivable	X (includes Medicaid)	X* (includes Medicaid)	X (includes Medicaid)		X (includes Medicare contractor receivables only, excludes Medicaid)	X (includes Medicare contractor receivables only, excludes Medicaid)
Cost Reports	X		X			
Net Position	X	X	X	**		
Pension Liability	X					
Initial Audit	X					
EDP Controls		X		X		X
Grants Oversight and Accounting		X (includes oversight)	X (excludes oversight)	X (excludes oversight)		
Medicare Claims Error Rate		X		X		
Intra-Entity Departmentwide Transactions			X			
Financial Reporting				X**		X
New Statements					X	
TOTAL	7	5	5	5	2	3
Resolved From Prior Year	Not Applicable	Not Applicable	4	1**	4	3
New	7	5	2	1	1	0

*Consolidated into one material weakness citing both accounts payable and receivable in FY 1996.
**Net position issue from 1996 was consolidated into financial reporting issue in FY 1997.

Scope Limitation

A scope limitation occurs when adequate audit evidence cannot be collected. A scope limitation may occur when (1) available accounting records do not provide adequate audit evidence to support the amounts reported in the financial statements, (2) time available to complete the audit did not permit the application of all necessary audit procedures, or (3) because of restrictions placed on the audit by the auditee.

Audit Opinions

Disclaimer of Opinion – Issued when the auditor has not collected sufficient evidential matter to form an opinion on the financial statements. The effects are so material that it would be inappropriate to issue a qualified opinion.

Qualified Opinion – Issued when there is 1) a lack of sufficient evidential matter, or 2) a departure from Generally Accepted Accounting Principles (GAAP).

Unqualified Opinion (Also known as a **"Clean Opinion"**) – Issued when 1) accounting principles used are appropriate, 2) disclosures are adequate, 3) data is presented in a reasonable manner, 4) underlying events and transactions are fairly reflected in the financial statements, and 5) the financial statements have not been materially affected by changes in accounting principles.

Statement on Auditing Standards (SAS) 70 reviews were conducted during FY 1998 for the following systems, and the auditors findings from those reviews were incorporated into the Departmentwide auditor's report:

- Payment Management System, PSC
- Center for Information Technology (CIT), NIH (formerly Division of Computer Research and Technology – DCRT)
- Central Payroll and Personnel System, PSC
- Division of Financial Operations, PSC

Additionally, auditors performed agreed-upon procedures related to the grant accrual calculation on year end financial statements.

SAS 70 – a review of the internal control structure of an organization that processes transactions or accounts for assets or liabilities of another entity.

In keeping with the U.S. CFO Council's "streamlining" philosophy of issuing one "accountability" document and one "planning" document per year, *the Department's* **Financial Management Five-Year Plan** *(to be published later this year) will provide detailed information on our plans and goals for improving our opinion and resolving our audit findings.*

Limitations of the Financial Statements

In accordance with OMB Bulletin 97-01, "Form and Content of Agency Financial Statements," we are disclosing the following limitations of the HHS FY 1998 financial statements, which are contained in this Accountability Report.

- The financial statements have been prepared to report the financial position and results of operations of HHS, pursuant to the requirements of the Chief Financial Officers (CFO) Act of 1990, as amended by the Government Management Reform Act (GMRA) of 1994.

- While statements have been prepared from HHS' books and records in accordance with the formats prescribed by OMB, the statements are different from the financial reports used to monitor and control budgetary resources, which are prepared from the same books and records.

- The statements should be read with the realization that they are for a component of a sovereign entity, that liabilities not covered by budgetary resources cannot be liquidated without the enactment of an appropriation, and the payment of all liabilities other than for contracts can be abrogated by the sovereign entity.

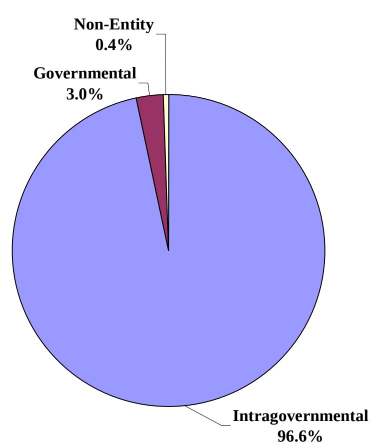
ANALYSIS OF FINANCIAL POSITION (BALANCE SHEET)

ASSETS

HHS had over $235.3 billion in total assets (including non-entity assets) at the end of FY 1998, compared to $217.7 billion at the end of FY 1997. This 8% increase is due largely to increased balances in the Medicare Trust Funds and in Fund Balances with Treasury at several OPDIVs.

The balance sheet separately identifies intragovernmental assets from all other assets. The bulk of HHS' assets are intragovernmental, meaning that they are HHS claims on other Federal agencies. These are for accounts such as the Medicare Trust Funds' Investments in U.S. Treasury Securities and the Fund Balance at Treasury.

HHS FY 1998 Assets



Most HHS assets are claims on the U.S. Treasury, and are categorized as Intragovernmental.

Assets Analysis by Account Type

When analyzed by account type, ***Investments*** made up almost 69% of total assets at FYE 1998, compared to 70% for 1997. These investments represent the cumulative excess of collections and appropriations over expenditures of the Medicare HI and SMI trust funds, which are invested with the U.S. Treasury Special Issue Securities. Treasury, in turn, uses these funds to finance other operations of the Federal Government thus reducing the need for Federal borrowing from the public. These securities had been accumulating since the inception of the Medicare program in 1966. According to the 1998 Trustees Report, 1995 was the first year that expenditures exceeded income and Medicare started to call upon its Trust Fund resources. These resources will continue to be called upon in years where annual expenditures exceed revenues.

Unlike the assets of private pension plans, Medicare trust funds do not consist of real economic assets that can be drawn down in the future to fund benefits. Instead, they are claims on the Treasury that, when redeemed, will have to be financed by raising taxes, borrowing from the public, or reducing benefits or other expenditures. When financed by borrowing, the effect is to defer today's costs to even later generations who will ultimately repay the funds being borrowed for today's Medicare beneficiaries. The existence of large trust fund balances, therefore, does not make it easier for the Government to pay benefits. Reflecting both the law and existing Federal accounting standards, no liability is recorded for benefits which may be paid in the future on behalf of today's workers who are currently paying taxes into the trust funds and who expect to be future beneficiaries upon their retirement.

The next largest category of assets is ***Fund Balance with Treasury*** at approximately 27%, which represents other undisbursed balances (largely appropriated funds, but also amounts related to revolving and other funds) held at the Treasury Department (which acts as a sort of bank for HHS).

Accounts Receivable from the Public (Net), at almost $5 billion (including non-entity receivables of almost $1.3 billion), and ***Loans Receivable (Net)*** at over $400 million, represent only 2.3% of HHS assets when combined, but are the focus of a great deal of attention from our debt collection initiatives. Most of the receivables originated with the Medicare program. Management has provided for a substantial allowance account (see financial statement Note 4), due to the questionable quality of receivables. The HHS 4th Quarter "Treasury Report on Receivables" reports that almost 51% of receivables are delinquent, with the bulk (75%) of total delinquencies being over one year delinquent. HHS' ***Non-Entity Accounts Receivable*** of almost $1.3 billion is attributed to receivables due from the public, such as those originating from disallowances identified during audits of grantees and contractors, which must be returned to the general Treasury fund.

Property, Plant and Equipment (PP&E), at almost $1.7 billion (net of accumulated depreciation) amounts to less than one percent of total assets, and is largely concentrated at NIH (numerous high technology research centers with high technology equipment), IHS (many facilities), FDA, and CDC. In FY 1997, the capitalization threshold was increased from $5 thousand to $25 thousand, reducing the burden of accounting for smaller equipment purchases.

Assets Analysis by Budget Function

When assets are analyzed by budget function (see supplemental schedules in Section IV), Medicare (with its own budget function category) holds the vast majority (70%) of HHS assets (composed largely of the Trust Fund account balances). The health budget function (which covers the Medicaid program, NIH, HRSA, CDC, SAMHSA, IHS, FDA and AHCPR), the second largest (18%), is composed mostly of Fund Balances with Treasury, with lesser amounts attributed to Investments and PP&E.

LIABILITIES

Relative to HHS assets, there are few liabilities. This is because neither Federal law nor Federal accounting standards recognize any long term liabilities associated with covering future Medicare costs for today's workers contributing to the system today who become beneficiaries upon their retirement. In other words, the amount of trust fund assets accumulated over more than three decades do not have an offsetting liability for future retirees.

Most of the HHS liabilities are for ***Accounts Payable*** due at fiscal year-end, typically for services provided under grants and contracts, and most are associated with the Medicare program. HCFA payables figure is largely an estimate made up of the value of services rendered to beneficiaries as of year-end which have not yet been reported to the Medicare program.

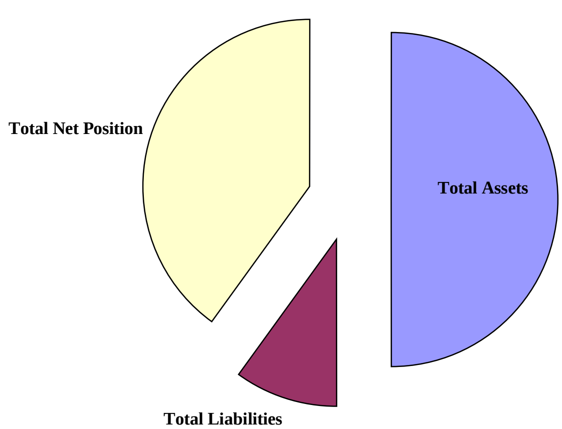
The noteworthy item in the HHS liabilities is the amount of ***Liabilities Not Covered by Budgetary Resources***, which are largely unfunded pension expenses of the Commissioned Corp recognized at PSC, but also include accrued annual leave and disability compensation for employees at all OPDIVs. The inherent differences between the way funds are appropriated in the Federal budget process, and how they are accounted for under generally accepted accounting principles (GAAP) cause these unfunded liabilities. Budgets are formulated on more of a cash basis, while GAAP is on an accrual basis. In other words, financial (accrual) accounting recognizes that the cost of today's HHS employees consists of today's salaries and benefits actually received, as well as the accrual of benefits to be paid out at a later date (for a "full cost" amount). Budgetary accounting delays recognizing the earned but unpaid benefits for years, until the payments are actually made to the employees/retirees. The Federal budget process does not recognize the future employee benefits costs of today's employees, but instead budgets for those future expenses in the future years when they are actually paid. The result is that while employee expenses (present and future) are recognized in accrual-based financial statements, they are under-represented in the cash-based Federal budget. This is one excellent example of the benefits of accrual accounting financial statements; there are no surprises regarding liabilities for employee benefits.

NET POSITION: BALANCE SHEET AND STATEMENT OF CHANGES

Net Position is the difference between total assets and total liabilities shown on the balance sheet. Starting in FY 1998, net position is only broken down into two categories: *unexpended appropriations* and *cumulative results of operations*. Two formerly shown categories, invested capital and future funding requirements, will be included in cumulative results of operations.

Unexpended Appropriations is the amount of authority granted by Congress that has not been expended or used. It is mostly attributed to ACF, NIH, and HCFA.

HHS FY 1998 Balance Sheet



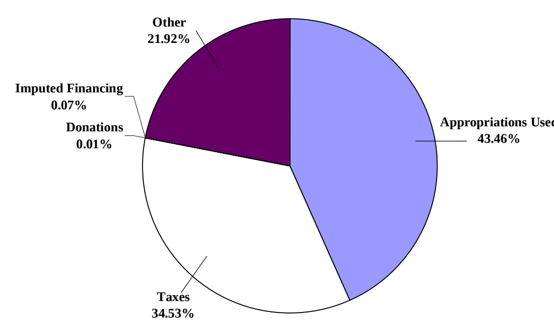
The asset side of the balance sheet equals the sum of liabilities and net position. HHS' large net position balance is due to the fact that, in accordance with Federal accounting standards, the long term Medicare trust fund assets to not show a corresponding long term liability.

Cumulative Results of Operations are the net results of operations since inception, plus the cumulative amount of prior period adjustments. HCFA accounts for most of the balance in the account.

For the first time in FY 1998, a new financial statement, the Statement of Changes in Net Position, is presented. This statement begins with the net cost of operations (taken from the Statement of Net Costs) and nets these costs with all sources of financing HHS received in FY 1998 (through appropriations or otherwise) to attain net results of operations. That amount is added to the increase in the amount of unexpended appropriations to determine the change in net position from FY 1997 to FY 1998. The amount of the change is then added to the Net Position beginning balance to arrive at the ending balance of $188 billion.

This statement provides more detailed information on non-exchange financing sources than can be found in other statements.

HHS FY 1998 Non-Exchange Financing Sources



The HHS FY 1998 Statement of Changes in Net Position reveals that general appropriations and taxes are the largest source of non-exchange financing.

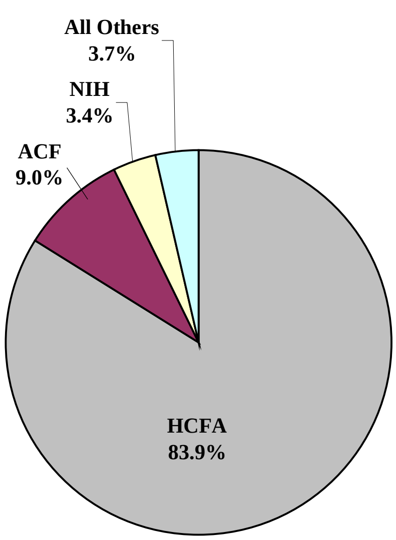
ANALYSIS OF NET COSTS

The new Statement of Net Costs can loosely be equated with the former "Statement of Operations" which focused on how the Department's money was spent, using such categories such as grants, salaries, contracts, etc. At the Departmental level presented in this Accountability Report, the net cost of operating each OPDIV is presented in aggregate and by budget function. There is little information for analysis. Details would need to be obtained from the individual OPDIV financial statements.

The FY 1999 GPRA annual performance plans identified 63 programs. Those programs are shown, for the first time, on the OPDIVs' respective FY 1998 statements. Due to this number of OPDIV programs, presentation and analysis of cost by program will, of necessity, be at the OPDIV level. The ODPIV financial statements will be available on their respective Internet Web sites. For reporting at the Departmental level, these programs have been rolled up by budget functions. HHS's largest budget function is Medicare.

In addition, the Statement of Net Costs will allow for linking program performance under GPRA reporting to the costs of programs reflected on the OPDIVs' respective statements. The concept of linking resources to results will finally be achieved by the display of total program costs.

FY 1998 Net Cost of Operations by OPDIV



HCFA, ACF, and NIH account for the largest percentages of HHS' FY 1998 Total Net Cost of Operations of $346.6 billion.

This substitution of the Statement of Net Costs for the statement of operations is one of the reasons why comparative financial statements are not presented this year.

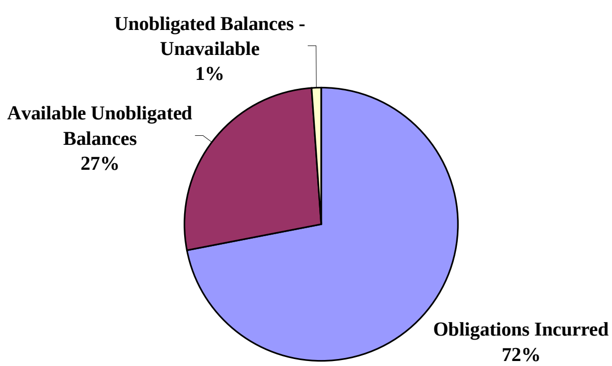
The format of the HHS-level Statement of Net Costs is now quite similar to the schedule of HHS FY 1998 net outlays by budget function and OPDIV (see Budgetary Highlights in Section I). The difference between the two is that the Statement of Net Costs represents expenses computed using accrual accounting techniques which recognize costs when incurred, regardless of the year the money was appropriated during the budget process. The net outlays chart in Section I identifies only the outlay (issuance of checks, disbursement of cash, or electronic transfer of funds) of those funds 'tagged' during the budget process as FY 1998 funds.

ANALYSIS OF THE STATEMENT OF BUDGETARY RESOURCES

The Statement of Budgetary Resources illustrates to financial statement readers how the budgetary resources were made available and the status at the end of the period. It presents the relationship between budget authority to budget outlays and reconciles obligations to total outlays. This is a fundamental change in financial statement reporting in that the budget process has never been a part of the financial statement audit process.

HHS prepared the Statement of Budgetary Resources for the first time for FY 1998, as required by new accounting standards. The purpose of the statement is to explain the sources of appropriated dollars and to provide the status (obligated or not) of those appropriated dollars. The total resources and the total status of budgetary resources equal the same amount. Thus, we have a type of budgetary "balance sheet." The statements show us that of the total $629.8 billion in FY 1998 HHS budgetary resources, they are largely derived from budget authority ($452.3 billion) and unobligated balances at the beginning of the year ($167.0 billion). The status section of the report reveals that most ($453.7 billion) of the resources appropriated have been obligated, although there is an unobligated available year end balance of $169.9 billion.

Status of Budgetary Resources at End of FY 1998



Most of the budgetary resources available to HHS during FY 1998 were categorized as incurred obligations at year end.

The Statement of Budgetary Resources also provides information on total outlays for the year, which is calculated by netting the beginning and ending obligations fund balance and adding the obligations incurred during the year (which is, incidentally, the same obligations incurred number reported earlier in the statement). Total FY 1998 outlays in the Statement of Budgetary Resources amounted to almost $436 billion. This amount excludes intrabudgetary transactions and proprietary receipts from the public such as those for Medicare's SMI (Part B) insurance premiums. When those amounts are included (as is practice for several budget execution reports) the figure becomes a total net outlays amount of $350.6 billion, a figure which is also used in this report (particularly in the section on budgetary highlights).

ANALYSIS OF THE STATEMENT OF FINANCING

The Statement of Financing is designed to provide the bridge between accrual based (i.e. financial accounting) information in the Statement of Net Cost and obligation based (i.e. budgetary accounting) information in the Statement of Budgetary Resources by reporting on the differences and reconciling the two statements. This reconciliation is needed to insure that there is a proper relationship between proprietary and budgetary accounts in the financial management system. In addition to the information it will provide, this statement will provide additional assurance about the reliability of the system that produces the accounting and budgetary information.

It is well known that the predominant form of accounting in the Federal government has been budgetary accounting. The advent of recent Federal financial management initiatives, starting with the CFO Act of 1990, started to introduce the concept of financial accounting to the Federal government. At times, this has created confusion among those who are only familiar with one way of Federal accounting. This statement will assist those who work with the budget to understand the financial statements and the cost information they provide. Therefore, this statement serves as a bridge between the two different bases of accounting. There are certain differences, such as timing differences, between budget numbers and financial statement numbers that will never change. The Statement of Financing will also serve to define and supply this information.

The Statement of Financing begins with the amount of budgetary obligations incurred ($453.7 billion) from the status section of the Statement of Budgetary Resources. The statement then provides a series of reconciling items totaling approximately $42 billion, most of which is attributed to timing differences related to Medicare and Medicaid accruals, in order to work toward the bottom line – the net cost of operations of $411.7 billion. This amount does not equal the Net Cost of Operations appearing on the Statement of Net Costs because the Statement of Financing does not include the eliminating entries which are included in the consolidated Statement of Net Costs.